Mutual fund growth to slow

Healthy cash flow to spur industry consolidation

The mutual fund industry is likely to enter a period of slower growth, although the changing nature of the industry could mean it is more likely to thrive during adverse economic swings, according to a new study.

The study, "The Mutual Fund Industry: After the Crash," conducted by Sanford C. Bernstein & Co. Inc., New York, also predicts industry consolidation is likely because of "substantial excess cash flow" during the next five years, even assuming slower growth rates.

The study forecasts industry assets will grow between 9% and 11% annually in 1988 and 1989. Although down from the 24% growth rate in 1987, the expected rate is much higher than the 2% growth experienced between 1974 and 1978.

Long-term full cycle industry growth should average between 15% and 18%.

"We believe the industry has fundamentally changed in the past decade, becoming a much more broadly based household savings vehicle," Bernstein reports.

The industry's expected growth should be fueled by a spurt — to 75% of total investments from 30% — in short- to intermediate-term fixed-income funds, the study predicts.

In light of the October crash, market uncertainties should feed households' penchant for substantially shortening maturities, according to the report.

Money market and other short-term fixed-income funds have been growing at a rate three times the growth of bank and thrift consumer deposits in the past four years, Bernstein reports.

"In fact, since the equity market crash in October, short-term mutual funds have increased by $33 billion, or 11%, while bank and thrift consumer accounts and (certificates of deposit) have grown by only $18 billion, or 1%," the study says.

This expected change in investment strategies will "marginally" reduce average management fees, but will "dramatically" reduce the pool of available incentive loads to brokers and to support marketing spending.

The study also predicts industry profit margins will decline 20% to 25% over the next several years.

Other changes predicted in light of the October crash include:

- Some form of Glass-Steagall reform, including an allowance for bank underwriting and sale of mutual funds;
- interest rates will be "quite volatile" in 1988;
- individual company earnings performance will depend on product mix, reputation and mode of distribution. ■

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holdings in an international index, GDP-weighted by country and capitalization-weighted within each market. This list has only 19 stocks in Japan. Eleven stocks are in Germany, six in France, five in Italy, three in Spain, two in the Netherlands, two in the United Kingdom, and one each in Australia and Austria. There can be no doubt which portfolio offers better diversification.

No one is interested in improved diversification if it can be achieved only at great cost. Japan through the years has had an extraordinarily growing equity market. Those investors who believe this success will continue are reluctant to cut their Japanese holdings. They might be surprised and comforted to know they could have reduced their Japanese exposure, using properly designed GDP-weighted strategy, and still outperformed a capitalization-weighted strategy in the past 18 years.

A GDP-weighted strategy requires more management than a market-weighted strategy. One of the most attractive aspects of a capitalization-weighted international index fund is that very little rebalancing is required. In fact, if stocks paid no dividends and there were no new issues, mergers or acquisitions, a "plain vanilla" international index fund would be "buy and hold" forever. There would be absolutely no trading costs beyond the initial investment.

A GDP-weighted strategy requires periodic rebalancing. Performance differentials between markets cause significant drift from the relatively static GDF weights. While the need for trading is a disadvantage because of transaction costs, it does build a systematic buy-low, sell-high feature into the strategy. Capital invested in countries that perform above average must be periodically reallocated into those countries that have underperformed.

Simulations for the past 18 years reveal long-term results are somewhat sensitive to the rebalancing technique.

Table 2 shows the year-by-year results of a GDP-weighted strategies compared to a capitalization-weighted strategy applied to the EAFE index. While it is obvious that in any given year, results in the two strategies can be quite different, the GDP-weighted strategy, net of estimated rebalancing costs, slightly outperformed the capitalization-weighted strategy by an average of 30 basis points a year.

A GDP-weighted international index fund is a logical next step in the evolution of international indexing. It is an attractive alternative for the investor who wants to maintain a passive approach to international investing, but is concerned with the increasing Japanese concentration of the standard approach.

A GDP-weighted strategy is more uniformly distributed around the world, offering improved diversification. It provides a systematic asset allocation scheme that historically has been an excellent performer, in spite of its relatively modest exposure to Japan. It is particularly timely for those worried that the Japanese market is overvalued.

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INTERNATIONAL

Index fund returns not exact match

By Marlene Givant

In international investing, comparing the performance of passive stock managers is almost as interesting as comparing active returns.

The complexities and expense of international stock indexing have led managers to use various sampling methods, which in turn have led to wide differences in performance among funds tracking the Morgan Stanley Capital International Europe Australia Far East index.

For example, Wells Fargo Investment Advisors' EAFE pooled fund returned 27.3% last year, compared with the EAFE's 25.2% and Chase Investors Management Corp.'s EAFE index fund's 24.3%.

Officials at San Francisco-based Wells Fargo said the performance difference is attributable to the fund's including only nine EAFE countries; the return is closer to that of a nine-country benchmark. The firm since has added six markets to its index because it hired Morgan Stanley Trust Co., New York, as its global custodian, assuaging concerns about settlement and capital repatriation in some markets. EAFE covers 18 countries and about 975 stocks.

Chase's fund experiences tracking error because it includes only 520 EAFE stocks, according to Charles Massare, vice president of the New York firm.

What's wrong with passive managers outperforming the EAFE — especially when few active managers have?

"On the premise that tracking error is a negative, positive tracking error ought to be as concerning to you as negative tracking error," said Nicholas Lopardo, chief investment officer of State Street Bank and Trust Co., Boston.

Indeed, pension executives say they pay careful attention to tracking error in evaluating indexers in international searches.

When the $540 million CIBA-GEIGY Corp. pension fund started international indexing three years ago, "We had viewed indexing as a quick, cost-effective way of becoming involved in international," said William J. McHugh Jr., director of trust funds for the Ardsley, N.Y.-based company.

"We were cognizant of the fact you can have a tracking error. State Street had a good record of closely following the index. (It followed) nine of the 17 markets (in EAFE) at that time so it was especially amazing they could do so well," he said.

CIBA-GEIGY invests $15 million in State Street's commingled fund.

Tracking error results from ranges in the assets in an index fund, the degree of replication and the number of countries and stocks included. Even the exchange rates and times used to calculate returns cause short-term gaps.

The Public Employees Retirement System of Nevada invests $65 million with Axe Core Investors, Tarrytown, N.Y., in a fund that tracks the EAFE using American depository receipts, which are receipts for shares of a foreign corporation that are traded in the United States.

"One of the reasons for tracking error in our portfolio is because . . . there aren't ADRs for that whole (EAFE) index. It's a stratified sample to replicate the index. You would expect some tracking error," said Laura Wallace, investment officer of the $2.5 billion Nevada fund.

All the major indexers agree the longer the time horizon, the lower the tracking error.

State Street and American National Bank & Trust Co. of Chicago, the oldest international indexers, started within a few months of one another in 1979. For the nine years ended Dec. 31, State Street's fund returned a compound annualized 21.1% vs. the EAFE's 21.6%. American National, which did not report for the full year of 1979, returned an annualized 22.9% for the eight years ended Dec. 31, vs. the EAFE's 23.6%.

The index's returns were obtained from the Pensions & Investments' Performance Evaluation Report.

State Street overshadows its competitors in terms of international assets for U.S. tax-exempt clients. It runs $4 billion in passive international accounts — $2.5 billion in passive separate accounts and $1.5 billion in a commingled index fund. American National runs $220 million, all in an EAFE index commingled fund.

Wells Fargo manages $800 million in EAFE commingled funds and Chase Investors runs $370 million overseas, including a $50.4 million commingled fund.

Both firms have been international indexers for almost seven years.

While a sizable tracking error

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EAFE index fund returns
(periods ended Dec. 31)

	Quarter	1 yr.	3 yrs.**	5 yrs.**
State Street Bank	−10.2	25.2	48.8*	34.5*
Wells Fargo	−9.8	27.3	48.1	33.5
Chase Investors	−10	24.3	50.6*	35.9*
American National/Chicago	−10.2	24.8	49.6	33.4
EAFE	**−10.5**	**24.9**	**49.3**	**34.9**

Source: Pensions & Investments' Performance Evaluation Report
* Data supplied by firm
** Returns are compound annualized

U.S. investors might export small-cap boom

By Joel Chernoff

International small-cap portfolios might emerge as a hot area in the next few years, as U.S. institutional investors delve deeper into international equities.

So far, there has been only a trickle into small-capitalization accounts, but some managers are unveiling products that promise additional diversification and higher returns with what some claim is actually lower risk.

"I think it will be a growing area, but it is still a real niche play," said Lawrence Davanzo, senior vice president at Wilshire Associates, Santa Monica, Calif.

"For funds large enough to consider diversification outside of the U.S. by types of equity investment, small-cap should be considered," said Carol Proffer, principal at William M. Mercer-Meidinger-Hansen Inc., Dallas.

The domestic rally in small-cap stocks also might boost pension executives' interest. The $2.7 billion Fire & Police Pension System — City of Los Angeles, which just hired six domestic small-cap managers to run $192 million, might consider hiring a small-cap manager in its upcoming search for international managers, said Allan Moore, assistant manager.

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Experts who believe small-cap international equities could be right for some pension funds — with limitations — include (clockwise from top left) Lawrence Davanzo, Wilshire Associates; Carol Proffer, Mercer-Meidinger-Hansen; Barry Gilman, PCM International; and David Booth, Dimensional Fund Advisors.

FEATURE

Privatization puzzle

Speculation tax may cool funds' ardor

By Nick Ryan

Fears of stricter interpretations of tax laws might cause British pension funds to shun privatizations of government-owned companies — including a pending $40 billion selloff of the electricity industry.

The concerns stem from recent efforts by the Inland Revenue — the U.K. equivalent of the Internal Revenue Service — to tax "speculative" investments made by tax-exempt investors.

These include profits gained from subunderwriting — where institutions guarantee to take any unsubscribed shares in return for a slice of the underwriting premium.

Also affected is a wide array of investments, including some involving derivative instruments, program trading, short-term bond strategies, gold and commodities.

Fears of taxation could set back the British government's continuing efforts to privatize various industries.

The electricity industry privatization, involving both generators of power and distributors of energy and electrical appliances, is expected to occur late this year or early next year.

Pension fund managers, many of whom are nursing their losses from subunderwriting British Petroleum last fall, increasingly feel that if profits from such sales are taxed, the exercise might not be worthwhile.

In the United Kingdom, investment banks traditionally share the risk with subunderwriters. With British Petroleum, underwriters got stuck with virtually the entire $12.6 billion issue, at a penalty of 90 cents per share.

The National Association of Pension Funds is pursuing the taxation issue, which it sees as having serious implications for London as a center for raising capital and for the tax status of pension funds, which have been participating in underwritings for years.

"The result of the BP share issue should remind (Inland) Rev-

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Privatization

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enue that the subunderwriting activities of pension funds do not always lead to a profitable return and taxation may result in funds turning away from this useful and important activity," said John McLachlan, outgoing chairman of the NAPF Investment Committee.

"If (subunderwriting) is taxed, some funds may wonder whether it's worth the management time," added David Prosser, investment director of Legal & General Assurance Society Ltd., a major insurance company with $40 billion in assets under management.

The Inland Revenue has set up a special office to investigate alleged "trading" activities by pension funds.

These short-term, speculative activities are distinct from longer-term "investments," but the law does not clearly define the differences between the two.

Much of the office's early investigation has centered on subunderwriting activity, but the current focus has been on other investments that might be regarded as speculative.

The special office is believed to be investigating about 10 plans; at least one, reported to have been dealing extensively in gold bullion, has been assessed for tax.

Other areas believed to be under investigation are:

- "soft" commodities. For example, a plan sponsor whose business is in the food industry might be tempted to use its in-house expertise and take a position in, say, cocoa futures.
- "bond washing." This involves active trading, particularly in short government bonds, just before and after a coupon date. Under this scenario, a pension fund would sell a bond to a taxable investor after the ex-dividend date but before the dividend is paid. After the dividend is paid to the fund, it would repurchase the bond, enabling the fund to register a tax-exempt gain while the taxable investor would walk off with a deductible tax loss.
- futures and options, including such things as currency hedging. The tax authorities believe it is all right for a fund to hedge its currency risk against specific holdings in a country, but takes umbrage if the fund were to buy Japanese stocks but hedged them in deutsche marks. That practice, they believe, would constitute a speculative activity.
- program trading and "bought" deals. If a fund buys a complete portfolio, it's unlikely to want to retain all the stocks in the deal. Some will have to be unloaded quickly. If that marginal short-term trade is considered taxable, it would alter the entire economic framework of the decision-making process.
- stock lending. While such loans to market makers could be very helpful in ensuring liquid markets; the "profits" are taxed, so pension funds avoid it. This might have contributed to problems after the Oct. 19 crash.

Said Clive Gilchrist of the $3.5 billion Merchant Navy Fund, Leatherhead, Surrey: "As an asset manager, I welcome the Inland Revenue's wish to clear up uncertain points of law. It is attempting to find out about and understand the investment strategy of pension funds. This clarification, if it can be done, will lift a cloud from the decision-making process."

But Colin Lever, senior partner of consulting actuaries Bacon & Woodrow, London, said: "There would have been easier and less painful ways for the Revenue to find out what was going on, if that was what they wanted.

"As it was, they created a lot of unnecessary worry and uncertainty. Nobody knew what they were up to or why, and there was no way to talk to them. All this shadow-boxing has wasted much management time." ■

Nick Ryan is University Superannuation officer of the University of London and secretary to the trustees of its pension plan, the Superannuation Arrangement of the University of London. He is a member of the Investment Committee of the National Association of Pension Funds (NAPF). Where an unattributed opinion is expressed in this article, the views are the author's and do not necessarily coincide with those of the university, the plan trustees or the NAPF.

Small-cap prospects

Continued from page 17

But foreign small-cap stocks are not for everyone, consultants and managers agreed. Those funds attracted to the area typically have several years' experience in international equities, are large enough to diversify their equity styles and view small-cap as a long-term investment.

Nevertheless, the returns can be spectacular. For the one- and two-year periods ended Dec. 31, Dimensional Fund Advisors Inc.'s $60 million Japan index fund returned 83.8% and 63.3% annually, respectively, compared with 32.5% and 55.1% for larger-cap Japanese stocks, said David Booth, chairman and chief executive officer of the Santa Monica, Calif.-based firm.

In the long run, foreign small-cap stocks have outperformed their large-cap counterparts.

In Japan, the lower half of the Tokyo Stock Exchange in terms of market capitalization has returned 28.8% a year from 1970 through 1987, measured in U.S. dollar terms, while the upper half returned 22.7% annually during the same period, according to DFA.

Meanwhile, in the United Kingdom, the Hoare Govett Smaller Companies Index showed a 20.6% annualized return from 1955 through 1987, fully 14 percentage points better than the Financial Times All-Share's 6.2% return. During 1987, small-cap stocks turned in one of their best performances, returning 21.1% compared with the FTA's 7.9%.

Canadian small-cap stocks have generated an annual average return of 12.2% since 1970, nearly double the 6.5% return enjoyed by the Toronto Stock Exchange 300 index, according to Burns Fry Ltd., Toronto.

The evidence stops there as similar data is not available for other markets. Anyway, lower average capitalization sizes in many other markets make such comparisons meaningless, where all but a few stocks may qualify as small-cap.

Thus, some small-cap managers make their biggest bets in Japan and the United Kingdom, with smaller allocations in Europe or among emerging markets.

PCM International, Newark, N.J, has more than 45% of its small-cap portfolio invested in Japanese stocks, with about 18% in the United Kingdom and the rest spread among continental Europe and other Southeast Asia markets, said Cassandra Hardman, portfolio manager.

Small-cap stocks hold out the seemingly contradictory prospect of higher returns for lower risk or the same level of risk, according to some.

For the 18-year period ended Dec. 31, the standard deviation for Japanese small-cap stocks was 25%, compared with large-cap stocks' 23.4%, according to Dimensional Fund Advisors. In the United Kingdom, they were nearly tied, with 31.5% for small-cap stocks and 31.3% for large-cap stocks.

Meanwhile, correlations of foreign small-cap stocks with the Standard & Poor's 500 index are even lower than for large-cap stocks, meaning investors can obtain even greater diversification, according to Mr. Booth.

In dollar terms, the correlation of Japanese small-cap companies is .137 vs. .237 for large-cap stocks; in the United Kingdom, the correlation is .266 for small-cap stocks and .334 for large-cap stocks.

The biggest concern is liquidity, especially in light of the October market crash when trading smaller-cap stocks was virtually impossible. Size limits also are a factor.

"We cannot run $2 billion in small-cap," said Barry Gilman, managing director and chief executive officer of PCM International, which has about $20 million invested in foreign small-cap stocks, including an $8 million portion of a mutual fund run for its parent, Prudential Insurance Co. of America.

In addition, the markets in which managers purchase small-cap stocks are limited. After Japan and the United Kingdom, the choice falls off sharply. Much of Europe has not been hospitable to small- cap stocks, although that might be changing in light of new cross-border takeover activity, new tax incentives and efforts toward a unified market in 1992. ■

Index funds

Continued from page 17

would be expected in specialized index funds, such as those tracking South Africa-free holdings or small-capitalization stocks, it also occurs in funds tracking EAFE.

Blake Grossman, vice president of Wells Fargo, noted because the EAFE index's total return doesn't deduct withholding taxes, "you'd expect a perfectly managed index fund to slightly underperform the index because of withholding taxes."

Cash flow, how income is treated (i.e. whether gross or net dividends are reinvested) and how often a fund is rebalanced can affect returns, said Chase's Mr. Massare.

Portfolios using sampling require more rebalancing and therefore incur more transaction costs, State Street's Mr. Lopardo said.

Tracking methods that aim to curb expenses can cause biases toward large-capitalization stocks because trading small-cap stocks is more costly.

Chase keeps neutral market weights but "optimizes" its EAFE portfolio by buying a smaller number of stocks, said Mr. Massare. "There can tend to be more large stocks, but we try to control that," he added.

Mr. Lopardo said the size of the fund keeps trading costs down. In 1987, 30% of stocks bought for new clients were crossed with stocks traded by existing State Street clients. One swap saved a client $800,000, he said.

The economies of scale attract clients. The firm's international assets tripled in 1985 and in 1986 and grew 50% last year.

He said State Street's commingled fund was able to perfectly track the EAFE over nine years largely because of the economies gained through its tremendous size.

But Jim Kartalia, vice president and director of marketing of American National Bank & Trust, argued small is better: "At our size, it's a lot easier to buy and sell stocks with little market impact." The firm's $220 million index fund excludes illiquid markets and stocks.

Other firms running international index funds for U.S. clients include Alliance Capital Management Corp., New York, which offers a South Africa-free EAFE fund; Bankers Trust Co. — Investment Management Group, New York; The Boston Co. Inc., Boston, which offers individual country index funds; Boston International Advisors Inc., Boston; County NatWest Investment Management Ltd., London; Dimensional Fund Advisors Inc., Santa Monica, Calif., which indexes small-capitalization stocks; Mellon Capital Management, San Francisco, which uses Salomon Russell Global indexes; Northern Trust Co., Chicago, which indexes stocks but actively weights countries; and the Travelers Cos., Hartford, Conn., which uses Financial Times Actuaries World Indexes. ■

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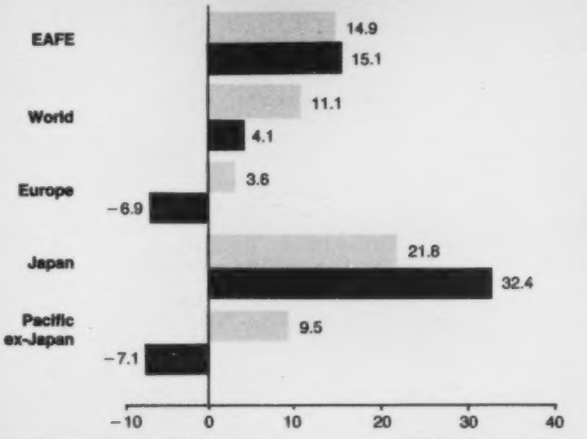
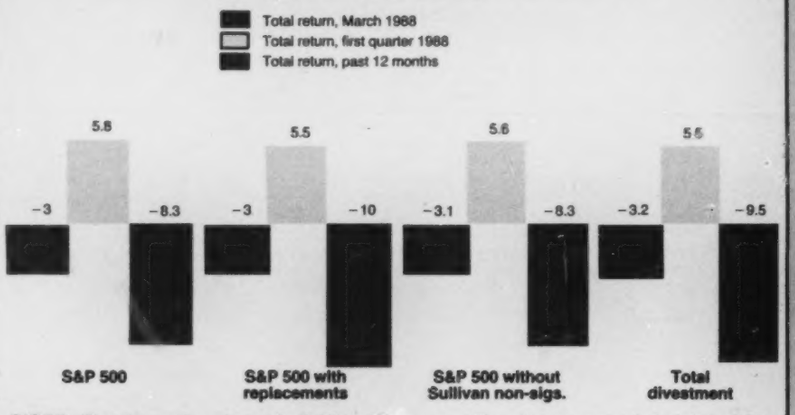
STATISTICALLY SPEAKING

Morgan Stanley Capital International worldwide indexes



Source: Morgan Stanley Capital International
Indexes are in U.S. dollar terms without dividends reinvested

South Africa Free Index

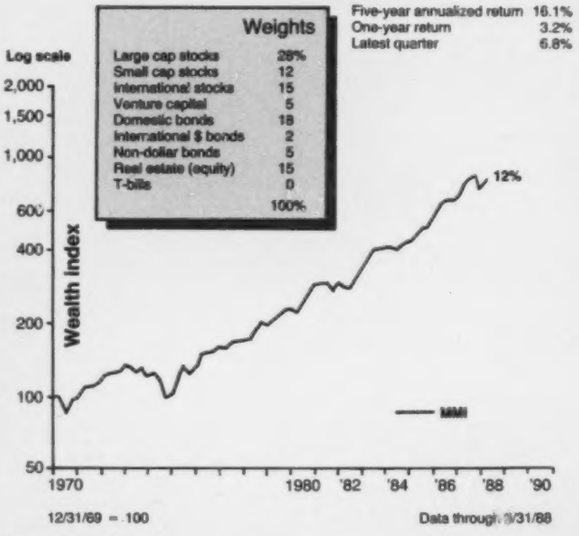


S&P 500 with replacements: replaces a South Africa-rel[illegible]ompany with next largest company in the industry. **S&P 500 without Sullivan non-signatories:** excludes 20 com[illegible]s, no replacements. **Total divestment:** eliminates all companies with South Africa involvement, no replacements.

Source: Wilshire Associates, Santa Monica, California

Multiple Markets Index

The Multiple Markets Index is a benchmark for total portfolio returns. It is composed of eight asset classes used by retirement plan executives; it is calibrated to reflect the same degree of risk of the typical pension portfolio; it uses passive fixed policy weights; and it represents the individual asset classes by the broadest and most complete market return data available.



Weights	
Large cap stocks	28%
Small cap stocks	12
International stocks	15
Venture capital	5
Domestic bonds	18
International $ bonds	2
Non-dollar bonds	5
Real estate (equity)	15
T-bills	0
	100%

Five-year annualized return	16.1%
One-year return	3.2%
Latest quarter	6.8%

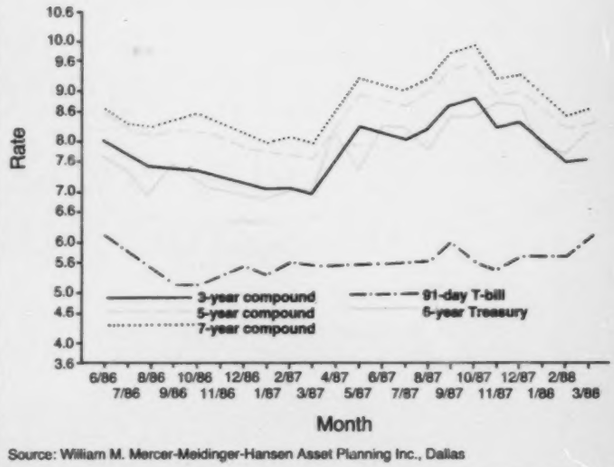
12/31/69 = 100

Data through 3/31/88

Source: First Chicago Investment Advisors, Chicago

Summary of average bullet GIC data vs. market yields

($1 million contract)



Source: William M. Mercer-Meidinger-Hansen Asset Planning Inc., Dallas

First quarter 1988 returns

	Russell 3000®	Russell 1000®	Russell 1000® by market capitalization				Russell 2000®
			Large	Medium/large	Medium	Medium/small	
Technology	-2 %	-3.7%	-7.1%	-3.9%	5.2%	9.5%	14.7%
Health care	7.6	6	4.3	5.1	15.4	11.4	23.7
Consumer discretionary	13.7	12.2	2	13.6	13.8	18.1	24.2
Consumer staples	4.5	4.2	-0.5	7	13.2	13.5	17.3
Integrated oils	15.7	15.6	14.6	25.5	7.8	29.8	42.5
Other energy	11.8	11.2	NA	11.6	9.5	16.2	15.6
Materials and processing	7.2	6	-6.6	3.9	9.9	15.5	17.1
Producer durables	8.5	7.2	-9.3	9.8	13.2	11.7	19.3
Auto and transportation	14.9	14.3	12.8	9.6	21.3	17.1	23.9
Financial services	8.3	8	-1.9	4.2	10.2	12.6	13.1
Utilities	5.3	4.9	4	2.9	8.1	8.9	17.2
Total	7.8	6.8	2.2	6.6	11.2	14	18.7

Source: Frank Russell Co., Tacoma, Wash.

Energy stocks perform best

By Trudy Ring

KANSAS CITY, Mo. — Energy stocks were the market's best performers in the first quarter, while telephone bonds led all fixed-income sectors, according to the quarterly analysis by DeMarche Associates.

For the 12 months ended March 31, energy stocks also had the best performance, while Yankee and foreign issues led the bond market despite their poor performance in the most recent quarter.

Energy stocks in the Standard & Poor's 500 stock index gained 13.4% in price in the quarter, while the entire index gained just 4.7%. Stock performance figures are price appreciation only; bond figures are total return. Equities in the energy sector lost 3.8% in the 12-month period, while the S&P 500 declined 11.6%.

The energy sector consists of stocks in domestic and international oil companies and oil services and equipment.

Stocks related to consumer spending were second for the quarter with a gain of 8%. For the 12-month period, they declined 11.4%. This sector includes household goods, food and beverage, tobacco, textile and retail stocks.

Basic industry stocks, 1987's best performers, fell to third in the quarter with a 4.3% gain. For the 12 months ended March 31, they declined 9.8%. Automotive, building materials, chemical, electrical equipment, metals and transportation companies are in this category.

Stocks sensitive to interest rates gained just 2.6% in the first quarter, after leading the market in the previous quarter. For the 12 months, these stocks were down 13.4%. The sector consists of banks, savings and loans, insurance companies and large gas and electric utilities.

Technology stocks had the quarter's worst performance, a decline of 1.2%. For the year ended March 31, they also came in last, down 16.4%. Aerospace, drug, electronics and office-equipment companies are in this group.

The 10 best-performing industries in the quarter were building materials, up 33.1%; textile products and apparel, up 27.3%; oil service and equipment, up 24.6%; special machinery, up 20.8%; integrated domestic oil, up 20.4%; air transportation, up 20.1%; retail sales, up 18.1%; auto parts and accessories, up 17.4%; aerospace, up 15.1%; and automotive — cars and trucks, up 14.1%.

The 10 worst-performing industries were office equipment, down 7.9%; aluminum and copper, down 6.9%; consumer household products, down 4.9%; electrical equipment, down 4.7%; consumer non-durables, down 2.3%; media, down 0.1%; chemicals, up 0.1%; paper, up 0.3%; electric utilities, up 0.9%; and beverages, up 1%.

The quarter's top 10 individual stocks were **Roper Corp.**, up 254.8%; **Firestone Tire & Rubber Co.**, up 149.2%; **J.P. Stevens & Co. Inc.**, up 123.7%; **Federated Department Stores Inc.**, up 121.7%; **Tektronix Inc.**, up 114.1%; **American Standard Inc.**, up 109.9%; **Koppers Co. Inc.**, up 83.3%; **Colt Industries Inc.**, up 82.1%; **Lucky Stores Inc.**, up 80.1%; and **Mohasco Corp.**, up 76.2%.

Besides analyzing the S&P 500 stocks by sectors, DeMarche also categorizes them by quality, growth and yield. As rated by quality of the issuing companies, below-average quality stocks performed best in the first quarter, gaining 9.3%.

As ranked by growth, variable growth stocks had the quarter's biggest gain, 6.3%. As rated by yield, the highest-yielding one-fourth of the market also had the best price gain, 7.9%.

In the bond market, telephone company bonds led for the quarter, with a return of 4.5%. The DeMarche Pension Fund Bond Index of 6,000 issues was up 4%.

Telephone issues had the poorest performance for the 12 months ended March 31, returning 2.7%. The DeMarche index was up 4.9% in that period.

Canadian issues ranked second in the quarter with a 4.4% return. For the year, they returned 4.6%. Utility bonds gained 4.3% in the quarter and 4% for the year.

U.S. government issues and industrial bonds each returned 4% in the quarter; their 12-month returns were 9.7% and 9.5% respectively. Financial company bonds returned 3.8% for the quarter and 5.8% for the year.

Yankee and foreign issues were the poorest performers in the quarter, returning 3.4%, but best for the 12 months, returning 7.3%. They had been the best performers of 1987.

As ranked by quality, below-average bonds had the quarter's best return, 4.3%. As rated by maturity, bonds in the 10- to 20-year range performed best, as they were up 4.5%. Bonds combining the characteristics of these categories had the best return, 5.3%, when ranked by quality and maturity combined. ■

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Funds select Hanseatic to hedge assets

LOS ANGELES — Whittaker Corp. hired Hanseatic-American Group Inc., Albuquerque, N.M., to hedge pension and 401(k) assets with an alternative to portfolio insurance, said Joseph Kleiman, a retired Whittaker senior vice president and consultant to the plans.

Hanseatic-American will provide an overlay hedging strategy, using stock index options, on about $60 million of the $100 million pension fund and $10 million of the $30 million 401(k) plan.

The manager will hedge, only when predicting a down market, by buying put options and selling call options. It will have authority to use futures to simulate options, but only if it cannot move in the options market, Mr. Kleiman said.

Whittaker formerly hedged the assets with a portfolio insurance program run by Oppenheimer Capital Corp., New York. Portfolio insurance, involving the sale of stock index futures in response to a portfolio decline, cushioned the fund somewhat in the October stock market decline, but didn't work as well as promised, he said.

The portion of the pension fund not covered by the Hanseatic-American hedging program is run by Kennedy Capital Management, St. Louis, and Davis, Weaver & Mendel Inc., Atlanta. ■

GIC rates tumble

Stable period to follow sharp decline

By Curtis Vosti

Rates on insurance company guaranteed investment contracts declined sharply at the beginning of the year, but observers say rates have firmed up as 1988 enters its second quarter.

"Basically, we saw a significant drop in the first quarter of the same magnitude as that of Black Monday (Oct. 19) but it was spread over a month and a half instead of a day," said Peter Bowles, president of Fiduciary Capital Management Inc., Woodbury, Conn. "Since then, there has been relatively little activity."

The drop coincided with what analysts say continues to be a strong demand for GICs, exacerbated by the Oct. 19 market fall.

Window GICs purchased shortly after the crash flooded the market in January, said Scott Sokol, director of investments for Chambers, Dunhill, Rubin & Co., Beverly Hills, Calif.

"Plans which were planning on transferring $1 million or so ended up having to transfer double or triple that amount" because employees were switching from equity investments in their 401 (k) plans, Mr. Sokol said.

He said some insurance companies suffered losses at the beginning of the first quarter because they had to hedge more than anticipated to cover the flood of GIC money at the turn of the year.

Messrs. Sokol and Bowles said, however, the use of GICs and similar instruments should continue to expand even though insurance companies have capacity limitations.

"The industry is reacting as you would expect," said Mr. Bowles. "The capacity is continuing to expand in a variety of forms."

The first quarter also saw a narrowing in the spread between GICs and Treasury securities of similar maturity by as much as 80 to 100 basis points, he said.

"What used to be 150 (basis point spread) on a five-year deal, you're lucky to get 70," said Mr. Sokol.

John Knight, president of Lamberson Knight Securities, a Short Hills, N.J.-based GIC brokerage, said he expects the second quarter to be less volatile, with rates fluctuating only about 30 to 40 basis points.

"At the beginning of the (first) quarter, the market had great expectations," Mr. Knight said. But concerns over renewed inflationary pressures dropped rates during the quarter until "right around March 1 when it turned around," he said.

Figures from William M. Mercer-Meidinger-Hansen Asset Planning, Dallas, show the average rate for a three-year, compound $1 million GIC March 4 was 7.52%; by April 1, it was 7.78%.

In December, the average rate was 8.39%.

"There may be some additional firming of rates, but this being an election year, you never know," Mr. Bowles said. "GICs are going to follow the general trend of traditional rates, though they don't go in lockstep with the other rates. I think the Fed is a major factor, no matter what you're talking about."

"I think you'd be throwing darts at a wall to figure that one out," Gene L. Gochenour, president of GIC Inc., Beaverton, Ore., said of the role of the an election-year Fed on interest rates.

GIC Inc. and Lamberson Knight provide insurance company rate quotations on representative five-year, single-deposit, simple-interest, $1 million GICs as follows:

- Allstate Life Insurance Cos., Northbrook, Ill.: March 31, 8.41%; Dec. 31, no quote.
- American United Life Insurance Co., Indianapolis: 8.36%; 8.7%.
- Bankers Life Assurance Co., Des Moines, Iowa: 8.12%; 8.53%.
- Canada Life Assurance Co., Toronto: 8.6%; no quote.
- Confederation Life Assurance Co., Toronto: 8.85%; 9.3%.
- Connecticut Mutual Life Insurance Co., Hartford: 8.37%; 8.56%.
- Crown Life Insurance Co., Toronto: 8.25%; 8.77%.
- Great West Life Assurance Co., Denver: 8.06%; 8.59%.
- Hartford Insurance Group, Hartford, Conn.: 8.55%; 8.85%.
- Home Life Insurance Co., New York: 8.21%; 8.64%.
- John Hancock Mutual Life Insurance Co., Boston: 8.41%; 8.53%.
- Life Insurance Co. of Virginia, Richmond: 8.7%; 8.48%.
- Massachusetts Mutual Life Insurance Co., Springfield: 8.13%; 8.62%.
- Minnesota Mutual Life Insurance Co., St. Paul: 8.63%; 9.31%.
- Mutual Benefit Life Insurance Co., Newark, N.J.: 8.3%; 8.75%.
- Mutual of New York, New York: 8.35%; 8.54%.
- New England Mutual Life Insurance Co., Boston: 8.02%; 8.66%.
- New York Life, New York: 8.35%; 8.8%.
- Northwestern National Life Insurance Co., Minneapolis: 8.37%; no quote.
- Ohio National Life Insurance Co., Cincinnati: 8.75%; 9.22%.
- Pacific Mutual Life Insurance Co., Newport Beach, Calif.: 7.92%; 8.48%.
- Pan American Life Insurance Co., New Orleans: 8.69%; 8.89%.
- Penn Mutual Life Insurance Co., Philadelphia: 8.82%; 9.12%.
- Phoenix Mutual Life Insurance Co., Hartford, Conn.: 8.5%; 8.94%.
- Provident Mutual Life Insurance Co., Philadelphia: 8.46%; no quote.
- Provident National Assurance Co., Chattanooga, Tenn.: 8.37%; no quote.
- SAFECO Corp., Seattle: no quote; 9.4% (Jan. 11).
- Southwestern Life Insurance Co., Dallas: 8.66%; 8.75%.
- State Mutual of America, Worchester, Mass.: 8.35%; 8.65%.
- SunLife of Canada, Wellesley, Mass.: 8.7% (March 29); 9.2% (Jan. 11).
- Union Central Life Insurance Co., Cincinnati: 8.63%; 8.83%.

Mercer-Meidinger-Hansen also surveys insurance companies for rate quotations, but does not identify the companies. A summary of various bullet GICs for March is as follows:

- Three-year, $1 million, compound: high, 8.23%; low, 6.83%; average, 7.65%.
- Three-year, $1 million, simple: high, 8.21%; low, 6.67%; average, 7.62%.
- Five-year, $1 million, compound: high, 8.94%; low, 7.52%; average, 8.31%.
- Five-year, $1 million, simple: high, 8.96%; low, 7.2%; average, 8.25%.
- Seven-year, $1 million, compound: high, 9.3%; low, 7.83%; average, 8.65%.
- Seven-year, $1 million, simple: high, 9.35% low, 7.7%; average, 8.54%.
- Three-year, $5 million, compound: high, 8.19%; low, 7.01%; average, 7.68%.
- Three-year, $5 million, simple: high, 8.21%; low, 6.85%; average, 7.65%.
- Five-year, $5 million, compound: high, 9.04%; low, 7.58%; average, 8.38%.
- Five-year, $5 million, simple: high, 8.99%; low, 7.57%; average, 8.31%.
- Seven-year, $5 million, compound: high 9.34%, low, 7.87%; average, 8.71%.
- Seven-year, $5 million, simple: high, 9.35%; low, 7.8%; average, 8.58%.

Dietrich & Associates, a Blue Bell, Pa.-based GIC brokerage firm, provided the following rate spread data between a $1 million five-year, simple interest GIC and the average Treasury note of the same maturity for 1988's first quarter:

- Jan. 4: GIC, 9.3%; T-note, 8.45%.
- Feb. 1: GIC, 8.60%; T-note, 7.74%.
- March 1: GIC, 8.65%; T-note, 7.64%.

The same information for the previous three quarters was:

- Dec. 9, 1987: GIC, 9.28%; T-note, 8.59%.
- Sept. 2, 1987: GIC, 9.5%; T-note, 8.59%.
- June 2, 1987: GIC, 9.05%, T-note, 8.19%. ■

Air Products names exec

ALLENTOWN, Pa. — Raymond A. Glennon has been named assistant treasurer of Air Products and Chemicals Inc., replacing David H. Kelly, who will remain an assistant treasurer but focus on corporate finance.

Mr. Glennon has been with Air Products 14 years. He most recently was director of its federal government relations office in Washington. He also has managed the employee benefits department and has had positions in tax, controllership and investor relations.

In his new position, Mr. Glennon is responsible for the investment of the company's $700 million in pension plan assets.

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Money managers rate America's best managed companies*

Vagelos

First

Merck & Co. Rahway, N.J.
Roy Vagelos, chairman, pres. & CEO
1987 cash compensation: $1,371,817 (includes bonus and deferrals)
Institutional holdings: 526 managers
Shares held: 52%, 136.7 million

	1987	1986	1985
Net income	906.40M	675.70M	539.90M
Revenue	5.10B	4.10B	3.50B
EPS	6.68	4.85	3.79

Common stock: 1987 low: 122 — high: 209 3/4
1986 low: 67 1/8 — high: 129 1/2

Second

General Electric Co. Fairfield, Conn.
J.F. Welch, chairman & CEO
1987 compensation: $2,056,887
Institutional holdings: 644 managers
Shares held: 44%, 915.3 million

	1987	1986	1985
Net income	2.90B	2.50B	2.3B
Revenue	40.50B	36.70B	29.2B
EPS	3.20	2.73	2.5

Common stock: 1987 low: 38 2/4 — high: 66 3/8
1986 low: 33 1/4 — high: 44 3/8

Welch

Glass

Third

Wal-Mart Stores Inc. Bentonville, Ark.
S.M. Walton, chairman & CEO
Cash compensation: $325,000*
David D. Glass, president & COO
1987 cash compensation: $488,000
Institutional holdings: 355 managers
Shares held: 31%, 564.5 million

	1987	1986	1985
Net income	450.10M	327.50M	270.80M
Revenue	11.90B	8.40B	6.40B
EPS	1.59	1.16	0.96

Common stock: 1987 low: $30 -- high: $53.88
1986 low: $21.81 — high: $33.88

* data for fiscal year ended Jan. 31, 1987

Quinlan

Fourth

McDonald's Corp. Oak Brook, Ill.
Fred L. Turner, chairman
1987 cash compensation: $166,198 salary; $356,250 bonus; $27,552 deferred
Michael R. Quinlan, president & CEO
1987 cash compensation: $449,948 salary; $270,000 bonus; $80,052 deferred
Institutional holdings: 435 managers
Shares held: 52%, 189.7 million

	1987	1986	1985
Net income	596.40M*	479.70M	433.00M
Revenue	4.90B	4.20B	3.80B
EPS	3.14*	2.48	2.22

Common stock: 1987 low: 31 3/8 — high: 61 1/8
1986 low: 32 1/2 — high: 51 1/8

* The 1978 net income and EPS figures reflect the cumulative prior year's effect of the change in accounting for income taxes.

Fifth

Digital Equipment Corp. Maynard, Mass.
Kenneth H. Olsen, president
Cash compensation: $905,706*
Institutional holdings: 504 managers
Shares held: 73%, 126.8 million

	1987	1986	1985
Net income	1.10B	617.40M*	446.70M
Revenue	9.40B	7.60B	6.70B
EPS	8.53	4.81	3.71

Common stock: 1987 low: 81 3/4 — high: 174 1/2
1986 low: 45 7/8 — high: 93 5/8

* for fiscal year ended June 27, 1987

Olsen

* The institutional holdings are based on Spectrum, as of Dec. 31, 1987. Salaries were taken from the latest proxy statements.

Merck tops best list

Continued from page 1
investment management unit of MCorp.

Merck produces human and animal health products as well as specialty chemicals that have application in water treatment, food processing, skin care and other fields.

Merck, Rahway, N.J., reported gains in income in 1987 because of such products as Vasotec, used to control high blood pressure, and Pepcid, a drug used to treat ulcers. The company also gained from sales of Recombivax HB, a hepatitis B vaccine made with recombinant DNA technology.

"The dedication of Merck's management team to building shareholder value was tangibly demonstrated in the major stock repurchase program (of $1 billion) and the maximization of sales growth for new products and even those that are more mature," according to a Goldman, Sachs & Co. report on the company.

The company's 1987 "financial results make delightful reading," said Neil B. Sweig, an analyst at Prudential-Bache Securities Inc., New York. Mr. Sweig, in a recent report, recited the good news about Merck in 1987: a 35% increase in operating income and a 37.7% increase in earnings per share.

The report also lauds the 7.9% increase in cost of goods, 28.5% of sales compared with 32.4% in 1986. This performance is "possibly (a) unique control of manufacturing costs for so large a company growing so rapidly."

Merck's future looks bright, Wall Street analysts say. If new drugs are as successful as expected, earnings per share should double by 1990, according to Cowen & Co. Institutional Services, Boston.

* * *

General Electric ranked high in the survey because of the company's nimble acquisition and divestiture of assets.

In 1987, for example, GE acquired CGR, a European-based medical diagnostics imaging business, from Thomson S.A. of France. In exchange, Thomson received GE's consumer electronics business.

This move bolstered GE's global medical systems business while allowing it to divest a business no longer considered strategically important, according to GE's annual report.

The company's varied mix of businesses insulate it from the dangers of recession. About 40% of its earnings come from units that do not track the general economic cycle — aircraft engines, aerospace, electric utility equipment and medical equipment — according to a report by H.P. Smith, analyst at Smith Barney, Harris Upham & Co., New York.

Although GE has reshaped itself substantially in the past few years, the company still has an appetite for acquisitions. "They will continue to make acquisitions that fit with their existing operations," said Linda M. Shuman, an analyst at Prudential-Bache.

Ms. Shuman praised GE's strategy, saying its acquisitions resulted in valuable synergies and leading positions in many markets.

"We have been a long-term holder of GE. I have high regard for Jack Welch (chairman and chief executive officer of GE). He's a good manager and has focused on the areas he wants to be in, divests of the others and pushes for profitable growth," said Grafton M. Potter, vice president and director of research, United Missouri Investment Counsel Service, Kansas City, Mo.

* * *

Wal-Mart Stores, a national discount department store chain based in Bentonville, Ark., took third in the survey.

Money managers credited the management team led by Sam M. Walton, chairman and chief executive officer and pioneer of the strategy of offering name-brand merchandise at low prices.

"Wal-Mart Stores' strategy has involved meticulous attention to detail and good old-fashioned business execution," said Eldon C. Mayer Jr., president and chief investment officer, Lynch & Mayer, Inc., New York. "They have decided to always be reducing prices. You can only do that by making a religion out of keeping costs down. They are many times better than the next best company in the retail industry."

Mr. Mayer said Wal-Mart stock, now selling at more than 20 times earnings, has been a cornerstone of the firm's investment portfolio. "We've owned them for years and never had a disappointing quarter," he added.

The company has performed admirably through the years, repeating a string of strong earnings reports. Net sales for the fiscal year ended Jan. 31, 1987, surged to record levels of $11.9 billion, up from $8.45 billion a year earlier. Net income for fiscal 1987 rose to a record $450 million, up from the previous year's record of $327 million, thanks in part to an aggressive sales and expense control program. Net income per share increased to $1.59 from $1.16 the year before. Operating expenses as a percentage of sales declined throughout the year. Shareholder equity, which in fiscal year 1986 exceeded $1 billion for the first time, grew an additional 32% in fiscal 1987 to $1.7 billion from $1.3 billion.

The growth and renovation program planned in fiscal 1988 includes the addition of 125 Wal-Marts, 20 Sam's, and the expansion or relocation of 55 older Wal-Mart stores.

Stephen F. Mandel, who follows Wal-Mart for Goldman, Sachs & Co., estimated in a recent report that earnings growth during the next five years will be about 20% to 25% annually. Although that range doesn't equal the 30%-plus rate Wal-Mart investors have seen historically, Mr. Mandel said it represents about three times the rate of the market.

"Its growth record almost speaks for itself," said Mr. Potter of United Missouri. "They've handled very rapid expansion very well," he said.

* * *

Investment managers rated **McDonald's** fourth among the five best managed companies they selected.

Noting most of the restaurant industry is in the doldrums, they pointed to McDonald's as a standout. They rang off a long list of attributes, including the vision and innovation of management, menu innovation, strong real estate management and operational efficiency that has been achieved throughout the company.

"Through competence and innovation, McDonald's has remained the quintessential company in a difficult industry. It has a superior record and has enjoyed continued success," said Peter Schliemann, senior vice president and director of research at David L. Babson & Co., Boston. "It's an excellent stock. Earnings come in strong year in and year out and it's a financially strong company."

Because of higher sales by existing restaurants, new restaurant expansion and the effect of stronger foreign currencies, McDonald's systemwide sales were up 15% to $14.3 billion in 1987 from $12.4 billion in 1986. Foreign sales also rose to $3.7 billion from $2.9 billion. Total revenue was up 15% to $4.9 billion from $4.2 billion, while net income also rose to $596 million from $480 million in 1986.

The food company's growth strategy focuses on adding more than 500 restaurants per year, with about 60% in the United States and 40% overseas. This year, McDonald's expects to open its first restaurants in Yugoslavia, Hungary and South Korea.

"McDonald's is poised to capitalize on its strong 1987 operating performance and should pick up additional market share in 1988. We anticipate that in 1988, the company will utilize a lower tax rate, cost savings from its new in-store processor and a strong promotional lineup to keep pressure on its fast-food rivals," Jay H. Freedman, who follows the company for Kidder, Peabody, said in a recent report. "With the aid of tax reform, which alone should boost the company's 1988 earnings by roughly 7.5%, and a normal year of new unit openings, McDonald's is virtually assured of a solid 12%-plus earnings gain for the upcoming year."

* * *

Digital Equipment, the computer manufacturer, was ranked fifth.

As was the case with McDonald's, money managers credited the company with performing well in a highly competitive and uncertain industry. While the stock has not been performing well of late, money managers said Digital's strategy would pay off in the long term even though the company now is out of favor.

"Over the years it's been one of the larger companies in the industry gaining market share in a tough competitive industry," said Jim Holmes, managing director, Dreman Value Management, New York. "They do it not by being the fanciest company but by offering quality products that meet their customers needs."

His firm only recently began buying Digital stock, which is relatively cheap, selling for about 9.5 times earnings. "They have good profit margins in an industry where profit margins are all over the board. The typical growth rate (for Digital) is 15% to 20% a year," Mr. Holmes said.

Third-quarter results for Digital, whose 1988 fiscal year ends in June, were considered decent on Wall Street, but clearly were affected by various industry pressures. Total revenue grew 17.2%, to $2.8 billion from $2.4 billion the prior year, while earnings per share showed only a fractional gain. Corporate orders rose about 19% worldwide.

George Elling, who follows the company for Merrill Lynch Capital Markets, said in a recent report the major disappointment during the third quarter was product sales grew only 12.4%, reflecting the hesitancy being expressed by minicomputer customers, especially for high-end systems. Margins were under pressure too. Mr. Elling looks for fourth-quarter earnings to exceed the $2.85 reported in the fourth quarter of fiscal 1987.

"From a stock standpoint, we believe that the bad quarter is now out and much will depend on whether Digital's U.S. customers regain confidence in the economy and begin to commit to high-end systems," the report said. ■

Market crash still being felt

By Brad Rudin

Although first-quarter financial results suggest some securities firms are still battling the effects of Black Monday, Morgan Stanley Group Inc. seems poised to turn in the kind of performance that made it the most profitable major securities firm last year.

Morgan Stanley boosted its first-quarter earnings 53% from the same period last year, while some of its Wall Street competitors — First Boston Inc., Merrill Lynch & Co. and PaineWebber Group Inc. — reported declining profits.

Net income slid 37% at Merrill Lynch, 36% at PaineWebber and 45% at First Boston.

The effects of last year's stock market plunge could be seen in reduced commission revenue at the retail-oriented firms. Reduced investment banking revenue undermined profitability at several Wall Street houses.

On the plus side, an upsurge in merger and acquisition activity boosted financial advisory revenue.

Principal transactions, which includes trading, risk arbitrage and other business for the firms' own accounts, also bolstered industry revenue.

"The one line that is better than everybody expected is the trading line," said Stephen J. Schwartz, an analyst at Shearson Lehman Hutton Inc. "A large portion of (the firms) were able to capitalize on the more positive fixed-income environment."

Several firms tried to buoy the bottom line with reductions in compensation and benefit expense. Comparing the first quarter of 1988 with the year-earlier period, compensation expense declined 32% at First Boston, 14% at Merrill, 4% at Salomon Inc. and less than 1% at PaineWebber.

Compensation and benefit expense increased 27% at Morgan Stanley. This item was not available for Shearson Lehman Hutton.

Salomon made a noteworthy comeback with a 16% increase in net income, which ended a nine-month decline in profitability.

Salomon's prospects for increases in profitability depend in part on the fixed-income markets, Mr. Schwartz said. "If rates really move up I doubt if they can sustain current levels, but I certainly think they will be profitable and make some nice money," he said.

Shearson Lehman Hutton saw profits increase almost 4% in the first quarter, the first period in which the firm's earnings from E.F. Hutton & Co. were included.

Merrill Lynch experienced a slide in earnings despite its position as the biggest underwriter of corporate securities in the first quarter. Investment banking revenue at the firm declined primarily because of "lower equity underwritings and the absence of any significant merger and acquisition transactions," according to a statement issued by the firm.

Merrill Lynch and PaineWebber will underperform the institutional-oriented investment banks because of the lack of retail business and the costs associated with the distribution system, according to a report issued last month by Mr. Schwartz.

"In our judgment, firms that focus on non-retail activities will continue to outperform not only because of the lower expense burden but also because of significant increases in certain lines of business, specifically (mergers and acquisitions), as well as a more positive fixed-income environment and potentially large risk arbitrage gains," the report said.

Although the investment banks with an institutional base are expected to report year-over-year earnings declines, these reductions in profitability will be more severe at firms with large retail branch networks, according to a report by Larry Eckenfelder, an analyst at Prudential-Bache Securities Inc.

Morgan Stanley attributed its first-quarter success to higher financial advisory revenue and debt underwriting fees, which offset a lower level of equity underwriting. The firm also reported revenue from sales and trading, asset management, foreign exchange and the commodities business contributed to the performance.

Investment banking revenue at Morgan Stanley increased 29%, to $197 million from $153 million, while revenue from principal transactions increased 16%, to $244 million from $211 million.

First Boston, which has been hurt by the defection of key investment bankers, sustained a 25% reduction in investment banking revenue in the first quarter. Trading losses in mortgage securities helped to shrink principal transaction revenue 31%, to $142 million from $207 million. ■

First-quarter brokerage firm earnings

	Net income ($ thousands)		Percent change	Earnings per share	
	1988	1987		1988	1987
First Boston	41,963	76,202	−45	1.17	2.09
Merrill Lynch	68,260	108,622	−37	.61	.97
Morgan Stanley	98,614	64,275	53	3.62	2.54
PaineWebber	20,761	32,597	−36	.48	1.02
Salomon	173,000	149,000	16	1.13	.96
Shearson Lehman Hutton	81,000	78,000	4	.81	*

* Shearson was not a public company in this period.

Source: Company data

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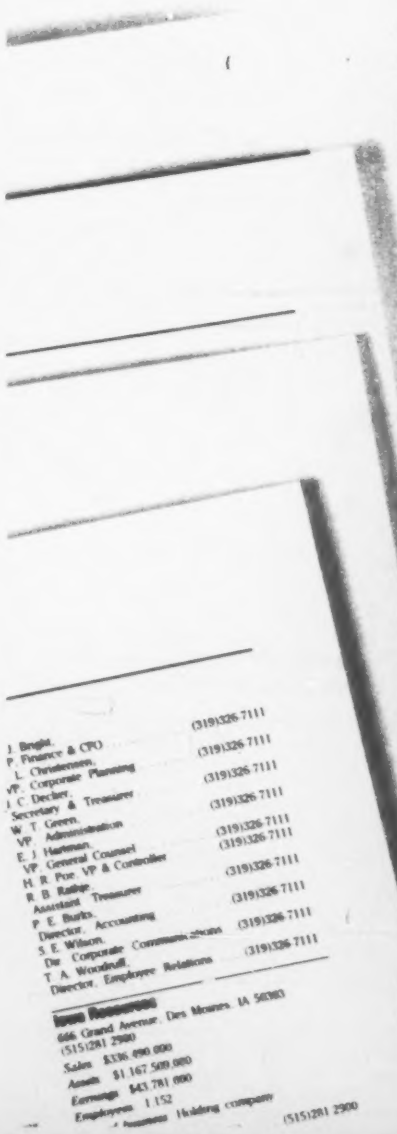

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Credit quality takes dip

By Brad Rudin

Credit quality in the first quarter sagged under the weight of takeover activity and weakness in the industrial and financial services sector.

The combined downgrades assigned by the five major agencies exceeded the number handed out in the fourth quarter of 1987.

Although the number of downgrades suggested a marked decline in credit quality, downgrades as a percentage of total rating actions produced a less dire view.

Still, the data broadly show a continuation of the downward trend in credit quality.

"A major factor in downgradings continues to be takeover mania," William A. Cornish, the head of the rating committee at Duff & Phelps Inc., said in a statement issued by the Chicago-based credit rating agency.

The rising volume of corporate takeover activity and recapitalization programs will undermine credit quality for the rest of 1988, rating agency analysts said.

"Given the number of announced bids we are seeing and the huge amounts of new financing that will be required to bring them to fruition, we expect special events will account for more corporate downgrades this year than in 1987," said Harold H. Goldberg, a senior vice president at Moody's Investors Service, New York.

Special events — mergers, acquisitions and stock buybacks — accounted for 24% of the corporate downgrades in the first quarter, Moody's reported. It cited Eastman Kodak Co.'s acquisition of Sterling Drug Inc., Shearson Lehman Brothers Inc.'s purchase of E.F. Hutton & Co. Inc. and stock buybacks at Allied-Signal Inc. and Hospital Corp. of America as examples of ratings lowered as a result of special events.

Ratings slipped sharply in the industrial sector, Standard & Poor's Corp. reported in Credit Week, with downgrades exceeding upgrades by a 2.3-to-1 margin in the first quarter compared with 1.3-to-1 for all of 1987.

The cost-plagued health-care industry suffered a sharp decline in credit quality, Standard & Poor's reported. But the agency also noted improving credit quality among some of the basic-metals producers — Aluminum Co. of America, Bethlehem Steel Corp., Inland Steel Co. and Inco Ltd.

Overall, downgrades accounted for 55% of the rating actions at Duff & Phelps in the first quarter compared with 61% in the fourth quarter of 1987. At Fitch Investors Service, downgrades made up 64% of the rating actions in the first quarter vs. 65% in the preceding quarter. Downgrades at McCarthy, Crisanti & Maffei Inc. accounted for 88% of the rating actions in the first quarter compared with 52% in the fourth quarter.

Downgrades accounted for 69% of rating actions at Moody's in the first quarter compared with 79% in the last quarter of 1987. At Standard & Poor's, downgrades made up 69% of the first quarter rating actions vs. 68% in the preceding quarter. ■

Corporate credit rating changes

	1st quarter 1988		4th quarter 1987	
	Up	Down	Up	Down
Duff & Phelps	20	24	12	19
Fitch Investors Service	5	9	6	11
McCarthy, Crisanti & Maffei	2	14	14	15
Moody's Investors Service	34	75	17	63
Standard & Poor's	57	127	33	71

Source: The rating agencies

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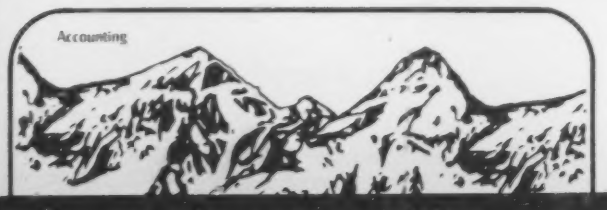

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Buybacks

Continued from page 1

William F. Harnisch, president of Forstmann-Leff Associates Inc., New York.

But Charles Plohn, a managing director in the equity transactions group at Merrill Lynch Capital Markets, New York, said six months isn't long enough to measure the effect of buybacks.

"I don't think you can judge the results of things on the basis of a few months because I don't think that that should be the purpose of a buyback program. It should have longer-term implications," he said.

A study by Georgeson, published in the firm's quarterly newsletter, focused on the short-term results of stock buyback announcements. "(T)hese buybacks barely affected share prices," Georgeson concluded.

Georgeson, a proxy solicitation and investor relations firm, examined all 114 companies in the S&P 500 that announced buybacks between Oct. 20 and Oct. 30. In a comparison with the stock index, Georgeson found the average stock in this group underperformed the market by 0.7 percentage points on a market-weighted basis in the first week after the buyback announcement. The group of 114 companies outperformed the market by 1.1 percentage points in the two weeks following the announcement, Georgeson reported.

Georgeson confirmed these findings in a study of 255 exchange-listed companies that announced buyback programs during the two-week period after Black Monday.

These companies underperformed the S&P by 0.5 percentage points from Oct. 19 to Oct. 30. In the first four weeks after the announcements, these companies lagged the index by 0.1 percentage points.

Still, the wave of buyback announcements following Black Monday did exert a positive influence on the market, Georgeson said: "While shareholders of the companies may not have benefited directly, they and other shareholders as well benefited indirectly from stronger markets which resulted from the slew of repurchase announcements."

IMI index futures contracts draw institutional concern

By Marlene Givant

Derivative contracts based on an international index with real-time pricing during the U.S. trading day are meeting skepticism from institutional investors.

The International Market Index was announced before Black Monday, but the Commodity Futures Trading Commission now is reviewing whether to allow a futures contract based on the International Market Index to trade on the Coffee Sugar and Cocoa Exchange. Meanwhile, the Securities and Exchange Commission is evaluating an IMI option that would trade on the American Stock Exchange, New York.

The CFTC has objected to proposed international-stock index contracts, such as futures on the Morgan Stanley Capital International Europe Australia Far East index, because of worries about pricing foreign indexes during trading hours in the United States while foreign markets are closed.

In addition, both the CFTC and SEC are concerned about how stock index derivative instruments address volatility in light of Oct. 19. The SEC has mandated that the AMEX adopt a surveillance agreement with key foreign exchanges on the IMI option, said Ivers Riley, AMEX senior vice president.

The IMI includes 50 blue-chip foreign stocks and large, high-quality American Depository Receipts, which are domestically traded receipts for shares of a foreign corporation. There are about 800 ADRs listed mainly on "pink sheets" which list quotations of over-the-counter stocks.

The index, which represents nine countries, would allow investors to manage international volatility with futures and options.

"If the existence of futures and options on domestic indexes makes perfect sense, then it makes sense on international too," said James Bowe, senior vice president of market development at the CSCE.

Institutions are concerned, however, the mostly ADR index might not generate sufficient support for a derivative market.

Meanwhile, the Chicago Mercantile Exchange is awaiting approval from the SEC and CFTC to trade futures and options and trade options on futures based on the EAFE index. The Chicago Board Options Exchange also might trade cash options based on the EAFE index.

Prices of EAFE stocks, which represent 19 countries, would be updated based on currency movements. IMI securities, which trade on the AMEX, New York Stock Exchange and the National Association of Securities Dealers Automated Quotations system, would be priced on a real-time basis.

Real-time pricing makes the IMI more attractive than existing international indexes that calculate prices at various points during the day, depending on the closing times of markets, Mr. Bowe said. Unlike existing indexes, the IMI reflects intraday currency fluctuations against the dollar in each of its securities' home markets.

Still, institutions aren't yet sold on the IMI concept.

Jeff Ricker, a consultant at Mellon Capital Management, San Francisco, which runs $19 billion for U.S. tax-exempt clients, said "we're pretty stuck on the (Standard & Poor's 500 stock index). We use the (Salomon-Russell Global index) for foreign stocks. To the extent ADRs are in those indexes, we would buy them."

Some investors might not like the IMI's large-capitalization emphasis. "The idea sounds interesting. Normally the problem of using an ADR portfolio is the large-cap bias. I suspect it is going to bother people," said Eric Seff, managing director of indexing and hedging of Chase Investors Management Corp. ■

Coming back

Continued from page 3

500 would have ranked slightly above the median.)

"I'm a great fan of Dean LeBaron," Mr. English added. "He's on the leading edge of investments. I would recommend (the firm) to anyone."

The Ford Foundation, nevertheless, dropped Batterymarch.

Although Mr. English said the fund wanted to run more money internally, it still employs about a dozen outside managers. When asked why the fund chose to retain those managers over Batterymarch, Mr. English suddenly decided to end the conversation.

Consultants interviewed said they haven't recommended Batterymarch in searches. Only some would speak for attribution.

Mr. LeBaron noted Batterymarch's widely publicized practice of trading at low commissions would make it unattractive in any case to some consultants.

At Lockheed Corp., Calabasas, Calif., which has a $5.5 billion pension fund, George C. Weintz, investment counsel, said, "We're asking a lot of questions" about Batterymarch. "There have been some disappointments." He declined to mention specifics, saying Lockheed, a client since 1979, is just beginning to look at the firm.

"If Dean wasn't such an intellect, such a forward thinker, he'd be long gone," Mr. Weintz added.

"Everyone I knew there, most of us knew there, is gone except for Dean," he added.

Mr. LeBaron describes Batterymarch as a contrarian, quantitative manager that follows a disciplined approach. The firm buys stocks according to themes, now weighted to industrial and energy stocks. A typical portfolio contains about 120 stocks in different weightings, a number that hasn't changed through the years.

He attributes the recent years of underperformance to three factors: its emphasis on small-capitalization stocks, which as a market subset had done poorly; the sharp decline of cyclical companies, which now are benefiting from a lower dollar; and the incomplete application of a theme that it calls "corporate valuation."

Of the latter, Mr. LeBaron said Batterymarch began applying the theme in the past three years. "Our first application of corporate valuation emphasized hard assets — working capital, real estate, book value," he said. But he added that it became clear that corporations value themselves in other ways as well, such as by unused debt capacity, technological competence and market share dominance. These less tangible aspects were only more recently incorporated into the corporate valuation theme.

Jeffrey O. Drinan, vice president at New South Capital Management Inc., Memphis, Tenn., recalls dropping Batterymarch when he was running the Federal Express Corp. pension fund.

He blames Batterymarch's fast growth for contributing to its performance problems.

"It's a typical story; they had $500 million or $1 billion under management when they did well," he said.

The growing asset size forced Batterymarch, a contrarian, "to become the ultimate contrarian and buy all the stocks everyone was dumping," he added.

Federal Express had $30 million with Batterymarch for three years, including two underperforming years, and terminated the relationship in 1986.

"Had we thought (there were) prospects for him to do better, we would have kept him," Mr. Drinan added.

"I doubt Batterymarch would do as well in the future as it did in the past when it had significantly less money."

Some other clients and former clients, who declined to comment for attribution, also cited Batterymarch's size as contributing to its underperformance. Batterymarch recorded its best string of results in the 1970s as a firm with relatively far fewer assets. It didn't reach $1 billion in assets until 1978. In the 10 years since then, ended Dec. 31, it has beaten the S&P 500 by an average 20 basis points a year, less than its management fee.

Mr. LeBaron, however, dismissed suggestions that the firm's size hurt performance. He noted the firm had a string of good years with billions of dollars under management in the early 1980s, adding the firm lately also has been outperforming. "I don't see much difference to running $12 billion or $9 billion," he said.

Concern also was expressed that Mr. LeBaron has been devoting too much time to global ventures, including a new Brazil fund, even though most of Batterymarch's assets are invested domestically.

Indeed, the bulk of the money for foreign clients — most of which are institutions — is invested in the United States. In addition, last year Batterymarch began a mutual fund for Japanese clients; that fund also is invested in the United States.

Batterymarch is working with New Japan Securities Co. and Yamaichi Securities Co. to introduce its U.S. investment approach to Japanese investors.

The $1.3 billion pension fund of Southern California Edison Co., Rosemead, cut back Batterymarch's assignment late last year. Rick Yamamoto, supervisor-pension investments, said the fund wanted to diversify equity managers more, noting it reduced exposure with two other managers, while hiring five others.

He acknowledged the Batterymarch reduction "was a recognition that something is going on," but added, "we're willing to hang on. We have confidence in Dean."

Mr. Yamamoto said fund executives were concerned about the staff departures, but aren't sure of their contribution to performance.

Mr. LeBaron is vague about the contribution the departing executives made to the investment process. He said their departure is healthy, allowing the firm to generate new ideas. He declined to blame them for poor ideas.

At the $3 billion State Universities Retirement System of Illinois, Champaign, Kenneth L. Codlin, investment officer, said Batterymarch's performance "is not something I'm presently losing sleep over."

He attributed the underperformance to Batterymarch's emphasis on small-capitalization stocks, which have rebounded only recently after relatively poor performance since 1983.

"If we were going to come to a view that small-capitalization stocks aren't going to do that well, that would be of concern," Mr. Codlin said. "But we don't have that view."

He also doubted Batterymarch's size is a problem: "It seems to me they can handle significant amounts of money."

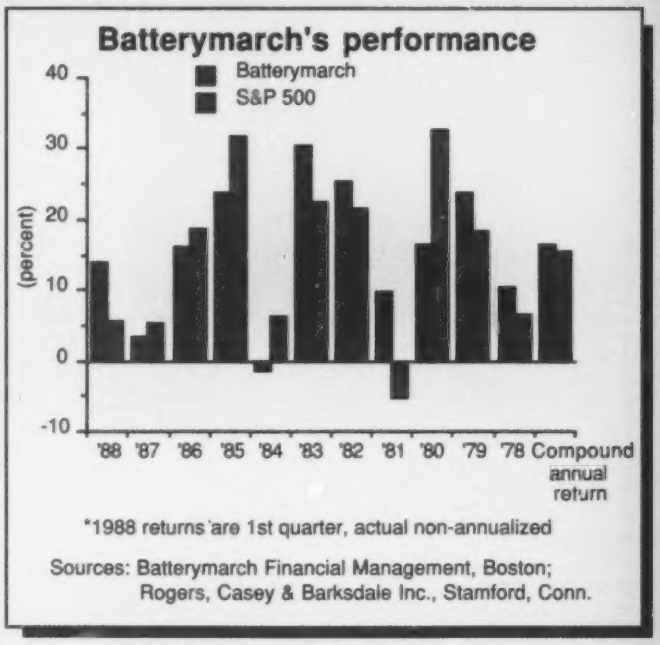
But he acknowledged Batterymarch is only for investors with long horizons and little need for liquidity.

Mr. LeBaron, unlike many other money managers, is open about his firm's record, a characteristic he said contributes to inspiring loyalty among clients.

But Mr. LeBaron said he might change the firm's presentation. He suggested scrapping the customary annual periods for measuring performance, preferring instead a "real" time, or constantly updated, basis.

In a recent conversation, he preferred to give performance under his real time scheme, a 20-month basis, ended March 31. During that time, Batterymarch returned 16%, compared with the S&P 500's 9%.

In addition, he said reporting of the firm's returns and style will become more complicated as Batterymarch moves toward customized portfolios, tailored for each client's objective and producing different outcomes, tied to different benchmarks. ■



*1988 returns are 1st quarter, actual non-annualized

Sources: Batterymarch Financial Management, Boston; Rogers, Casey & Barksdale Inc., Stamford, Conn.

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PENSIONS & May 16, 1988

Investment Age

Finance boutiques thrive

By Marcia Parker

In a two-part series starting in this issue's Financing section, *Pensions & Investment Age* takes a look at the highly competitive and fast-growing field of investment banking boutiques. More than 24 firms will be profiled, only a sampling of those serving the marketplace.

The willingness of institutional investors to bankroll leveraged buy-outs and corporate financings and restructurings is propelling fundamental changes in American corporate finance.

Most noticeable is the rise of boutique investment banking firms, which are in the throes of raising $12 billion from investors.

As a result, the already competitive investment banking market has become even more cutthroat, with the investment banking boutiques — especially those formed by defectors from huge Wall Street firms — commercial banks and insurance companies pursuing clients and investors once the sole domain of the traditional Wall Street firms.

In addition, a few institutional investors are breaking new ground by getting investment bankers, such as the Blackstone Group, to surrender to them a piece of the lucrative advisory fees the firms' earn.

And some corporate pension fund executives, normally prime targets of money-raising marketing efforts, are being bypassed because investment bankers go directly to the chief executive officer, with whom they have prior business relationships.

All investment bankers, however, are turning increasingly to a relative newcomer to these corporate finance-type investments — the Japanese. Many of

Continued on page 37

2 investors halt buy-out

By Carol Wiley

CHICAGO — A pension fund and a financial services company used their shareholder muscle to block the proposed buy-out of G•R•I Corp. by a management-led investor group.

The $742 million Minneapolis Employees Retirement Fund, which owns about 7% of G•R•I's outstanding shares, and Fidelity International Ltd., London, which owns about 29% of the shares, rejected the $10-per-share or $225 million offer saying management had not given the board of directors sufficient time to evaluate the bid nor a fair price for the outstanding shares. (The stock closed at $9.62 May 11.)

Robert Logan, interim chairman of the G•R•I board, said because the two institutional investors control 36% of the stock, and Illinois law requires approval from 67% of shareholders before a buy-out can proceed, the board voted unanimously to reject the proposal.

Less than a week after the buy-out was defeated, the board removed David Rubin, G•R•I's chairman and chief executive officer and leader of the buy-out effort, from the executive committee of the direct-mail marketing firm. Mr. Logan said the board decided it was "inappropriate" for the leader of the management group to serve on the committee, because any other proposals would have to be screened by the committee before being presented to the board, and "we want the committee chaired by someone not involved. It is not a rebuke."

Mr. Rubin was replaced on the executive committee by board member Jerome H. Stone, retired chairman and chief executive officer of Stone Container Corp.

Mr. Rubin, other senior executives and affiliates of the Frontenac Co. venture capital firm, had submitted a proposal May 4 to buy the company.

In a statement, Mr. Rubin said board members rejected the offer because they did not have "adequate time to evaluate it" before the offer expired, and because more than 35% of the shareholders found the $10-per-share offer "not acceptable."

G•R•I board member John Chenoweth, executive director and chief investment officer of the Minneapolis pension fund, said he objected to the proposal and voted against it because of the time limitations

Continued on page 38

Wide World Photos

Downtown L.A. fire puts LOR in the hot seat

Leland O'Brien Rubinstein Associates Inc. and other financial services firms faced a fiery challenge May 5, when four floors of Los Angeles' First Interstate Bank Tower were gutted by a blaze. But some foresight and a bit of luck let the firms handle business as usual after the calamity. Story on Page 4.

Another bright idea?

GE registers money management unit

By Marlene Givant

STAMFORD, Conn. — GE Investment Management Inc. has registered as an investment adviser with the Securities and Exchange Commission, furthering General Electric Co.'s drive to be a major player in financial services.

The new firm, whose parent has produced a string of winners in such businesses as financing and leasing, joins other in-house investment units that are competing head-to-head with money managers for pension fund accounts in an already crowded market.

Although top executives of the new firm declined to comment, sources confirmed GE Investment Management, Stamford, Conn., will tap the professional and support staff of GE Investment Corp., which runs $30 billion in company assets, including GE's $20.7 billion pension trust.

In addition to the two investment management units, GE Financial Services, with assets exceeding $50 billion, also owns 80% of Kidder, Peabody & Co., General Electric Credit Corp. and Employers Reinsurance Corp., a property and casualty reinsurer.

The GE pension fund is 98% internally managed by the subsidiary. Externally managed investments include a portion of the GE pension

Continued on page 37

INSIDE

PIPER first-quarter winners — P. 28